Internal Audit Services

Peoples Energy, LLC
Services and Transfers Agreement Audit
(Audit #2013-1002)

April 26, 2013

4/26/13
Shannon McNeil 4/26/13
4/26/13
4/26/13

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Background

Peoples Energy, LLC ("PE LLC") entered into a Services and Transfers Agreement ("Agreement") on February 7, 2007, with The Peoples Gas Light and Coke Company and its subsidiaries ("PGL"), North Shore Gas Company and its subsidiaries ("NSG"), and other subsidiaries of PE LLC. The Agreement sets forth the policies and procedures governing transactions relating to the furnishing of facilities, provision of services, and asset transfers between any parties to the Agreement and the allocation of joint service costs between them.

The Illinois Commerce Commission's ("ICC") Order approved this Agreement in Docket 06-0540. Consistent with the approvals granted by the ICC, PE LLC became a wholly owned subsidiary of Integrys Energy Group, Inc., PGL and NSG remained wholly owned subsidiaries of PE LLC, and Integrys Business Support ("IBS") was created as the new shared services company, effective January 1, 2008.

PGL and NSG file the annual "Summary of Affiliated Interest Transactions" report ("Report"), required by Article X.4 of the Agreement, with the ICC, and provide a copy to the ICC Staff by March 31 of each year to comply with the Agreement. Article X.4 of the Agreement requires that the Report include the following:

(i) A description of services and charges provided by PGL and/or NSG to other parties under the Agreement;
(ii) A description of services and charges provided by other parties to PGL and/or NSG under the Agreement;
(iii) PGL's and NSG's monthly billing to, and payments received from, other parties under the Agreement;
(iv) The amounts of any allocated costs under the Agreement; and
(v) Supporting calculations for each allocation.

Article X.3 of the Agreement requires an audit of the Report and intercompany transactions by April 30 of each year. By submitting this audit report to the ICC by April 30, we are fulfilling the audit requirement for calendar year 2012.

Objectives, Scope, and Sampling Methodology

Objectives

The objectives of our audit were to review the following on a sample basis:

- Services and charges, including allocated costs and supporting calculations, provided by PGL and/or NSG to, or received by PGL and/or NSG from, other parties under the Agreement;
- Whether intercompany bills between parties under the agreement are paid accurately and timely; and
- Accuracy of the Report filed with the ICC by March 31, 2013 (90 days after the end of PGL/NSG's fiscal year, which was December 31, 2012).

Scope and Sampling Methodology

The scope of our audit was all of the 2012 intercompany transactions outlined in the Agreement. We used a statistical sampling methodology to review $71.8 million of the $100.8 million of reported transactions. We judgmentally sampled an additional $0.6 million of transactions to ensure that adequate combinations of charges were included in our sample and performed additional analytical testing on these charges. We also statistically sampled 14 intercompany bills to validate accuracy and timeliness of payment. In addition, we selected a statistical sample of months to validate the accuracy of charges on the Report filed with the ICC.

Conclusion

During our review, we identified several minor errors in the draft Report and verified that General Ledger ("GL") Accounting corrected them prior to the submission to the ICC on March 26, 2013. In addition, we noted one invoice used an unsupported allocation rate for PGL and NSG in the 2012 intercompany transactions tested. Finally, we noted that all intercompany bills selected for testing were paid accurately and in a timely manner. We concluded that the intercompany billings and the information submitted in the filed Report were accurately reported and met the requirements as defined by Article X.4 of the Agreement.

We would like to thank all parties involved for their cooperation and assistance during the course of this review.

We conducted the audit in accordance with the *International Standards for the Professional Practice of Internal Auditing.*

Observations, Recommendations, and Action Plans

1.0 PGL/NSG Advertising Allocation Rates

Observation:

During our review of intercompany charges, we noted that the allocation rates used for advertising expenses, although reasonable, were unsupported and not consistent with other allocations used by Corporate Communications. They used an 80% PGL and 20% NSG allocation rate, instead of the customer count allocation that is more commonly used for other allocations within this area (84% PGL and 16% NSG). Compared to this alternative allocation rate, Corporate Communication's current allocation method resulted in an over-allocation of approximately $1,500 to NSG and an under-allocation to PGL of the same amount for the advertising expense transaction in this sample.

Recommendations:

1.1 We recommended that Corporate Communications determine an allocation rate that is supportable and more appropriate for allocating advertising expenses between PGL and NSG.

1.2 We also recommended that GL Accounting and Corporate Communications evaluate if there were any other advertising expenses allocated during 2012 using the 80% PGL and 20% NSG allocation rate and evaluate whether an adjustment should be made to correct for the difference.

Client Response and Action Plan:

1.1 Corporate Communications agreed with the recommendation and will use customer count as an allocation rate for advertising expenses between PGL and NSG. This change was already made mid-year 2012.

1.2 GL Accounting agreed with the recommendation and will not make any correcting entries due to the immateriality of the differences noted.

Responsible Person:

1.1 Debra L. Wendt, Manager, Customer Communications
1.2 Leslie A. Dorsey, Senior Accountant, GL Accounting

Completion Date:

1.1 April 23, 2013 – Completed
1.2 April 23, 2013 – Completed

Internal Audit Opinion:

We agreed with the Client Response and Action Plan. We have validated that the remediation is complete.

2.0 PGL/NSG Intercompany Testing

Observations:

For the 2012 PGL and NSG intercompany charges selected in our sample, we performed the following tests:

- Selected a sample of direct and allocated charges on the bills based on charge type and materiality and agreed them to source documentation;
- Reviewed the charges sampled to ensure that they were appropriate, accurate, at cost, and either directly charged or allocated based on appropriate allocation methods; and
- Performed additional analytical testing on labor, inventory, and intercompany interest charges to identify potential errors.

All charges we reviewed during intercompany transactional and analytical testing were accurate, appropriate, and reasonable. We did not note any issues other than what was noted in Observation 1.0.

3.0 Payment of Intercompany Bills

Observation:

During our review, we verified that our sampled intercompany bills between affiliates were paid within 10 business days, as required by the IBS Affiliated Interest Agreements ("AIA"). The PE LLC Agreement did not list any specific requirements, so we tested against the IBS AIA guidelines used across the company to be consistent.

4.0 Accuracy of the Annual Report

Observation:

During our review of the Report, we noted the following:

- PE LLC timely submitted the 2012 Report to the ICC, as required by Article X.4 of the Agreement, on March 26, 2013 (due on March 31, 2013) and
- We compared amounts reported on the Report to supporting documentation for both reasonableness and accuracy for a sample of months. Based on our testing, we identified several minor errors in the draft version of the Report and verified that GL Accounting corrected them prior to the final submission to the ICC on March 26, 2013. All of the items reported in the final version agreed to adequate supporting documentation and reflected proper intercompany services between PE LLC and its subsidiaries.